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AUTHOR	Adams, Rodney H.
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ABSTRACT

Investment trends and the total return concept discussed at the NACUBO Regional Investment Workshop are described. A survey was made by the NACUBO Committee on Investment of 1,059 institutions, 189 of which responded. The most important finding was that 26 institutions reported the adoption of total return investing. Other findings were that about 50 percent of the respondents classify and distinguish between endowment and quasi-endowment funds; over half operate an investment pool on a market value basis; all of those respondents have adopted the unit market value method for fund share accounting; and most institutions employ a single external advisor, with a small number having multiple advisors. The total return concept consists of two elements, yield and appreciation, and has a dual basis, one beging an investment performance objective and the second a systematic withdrawal or portfolio assets to augment investment yield. Investment objectives for colleges and universities are described and related to this concept. Attention is also directed toward the Uniform Management of Institutional Funds Act, which is being drafted to be applicable to all endowment funds. Recent tax legislation, especially the Tax Reform Act of 1969, is also reviewed. (LBH)

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CURRENT TRENDS IN COLLEGE AND UNIVERSITY INVESTMENT POLICIES AND PRACTICES

By Rodney H. Adams

The purposes of this paper are to describe current trends in investment practices of colleges and universities and also to report on the *Total Return Concept* and the NACUBO Regional Investment Workshop on this subject during 1971. In addition, I would like to describe the now occurring and anticipated future events that affect investment policies.

NACUBO Survey on Investment Practice

This survey was undertaken by the NACUBO Committee on Investment, under the coordination of John F. Meck of Dartmouth College. As of the last interim report on findings, there were 189 completed responses to the 1059 institutions surveyed. Responses by regional association were: Eastern, 72; Central, 59; Southern, 34; and Western, 24.

To me, the most important finding was that 26 institutions reported the adoption of Total Return Investing. A partial listing would include Yale, Dartmouth, Cornell, Chicago, Wesleyan, Brown, Johns Hopkins, Smith, Pomona, and Stanford.

Other points of interest in the preliminary findings were that about half of the respondents classify and distinguish between endowment and quasi-endowment funds, with an additional 20 percent now using this process of classification. Over half of the respondents operate an investment pool, on a market value basis, and virtually *all* of these respondents have adopted at some point the unit market value method for fund share accounting. In a query on investment management, the only significant answers showed that most institutions employed a single external advisor, with a small number having multiple advisors.

In his first report as president of the Ford Foundation, McGeorge Bundy commented that room exists for great improvement in the investment performance of college and university endowment funds. Further, he said:

We recognize the risks of unconventional investing, but the true test of performance in the handling of money is the record of achievement, not the opinion of the respectable. We have the preliminary impression that, over the long run, caution has cost our colleges much more than imprudence or excessive risk taking.

During 1969, two reports to the Ford Foundation were published: *The Law and the Lore of Endowment Funds*, by William Cary and Craig Bright; and *Managing Educational Endowments* by an Advisory Committee on Endowment Management. In 1970, the NACUBO *Professional File* included two issues focused primarily on the legal issues surrounding total return investing: a May issue by Blackwell and Johns, which took an opposing view to the submissions of *The Law and the Lore*; and a December reply by Cary and Bright. The two Ford reports describe and encourage what has become known as the *total return concept*.

Total Return Concept

Total return consists of two elements, *yield* and *appreciation*. Yield represents dividends, interest, rent, and the like. Until recently, only yield has been used, as endowment income, to support current operations. Appreciation is enhancement in the market value of investments held and may be either realized or unrealized. While for purposes of total return there is no distinction between realized and unrealized appreciation, an institution may wish to distinguish between the two for accounting purposes. Gain and appreciation are synonymous. In *The Law and the Lore* the comment is made that "for the past century the annual return on unselected common stocks, as a group, has been double that of high-quality fixed income securities." Further, the report states as its major submission:

We are led to the conclusion that there is no substantial authority under existing law to support the widely held

Rodney H. Adams *is Manager, Investments, at Stanford University where he is responsible for relations with external advisors, for cash management, banking relationships and similar treasury operations. He is currently serving as a NACUBO representative on the Advisory Committee on the Uniform Act for Management of Institutional Funds.*

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view that the realized gains on endowment funds of educational institutions must be treated as principal. No case has been found which holds that such an institution does not have the legal right to determine for itself whether to retain all such gains or to expend a prudent part.

The total return concept developed from the foregoing has a *dual basis*, one being an investment performance objective and the second being a systematic withdrawal of portfolio assets to augment investment yield. Total return investing is not a new concept; investment return studies have shown the historical data to support the concept as far back as the 1930's. T. Rowe Price, in coining the words "growth stock," implies this type of return objective and then some. I imagine you all have put your own personal dollars into total return investing to cover your retirement. You must certainly have done this if you are in the College Retirement Equities Fund, which started with total return investment objectives in 1952.

Investment Performance

The need to focus on investment objectives is a requirement in pursuing total return and in recognizing the dual basis of that concept. In the report, *Managing Educational Endowments*, a detailed examination is made of the adverse consequences of the failure to establish the clear-cut objective of maximum long-term total return. I take issue with blind adherence to some undefinable "maximum total return," as advocated in the report. The most important issues are the setting of objectives and, second, the measuring of performance in accord with those set parameters.

Let's look at some historical data for reference. One study I have seen combined the 1939 Cowles Commission Report and Standard and Poor's 500 Stock Index since 1939, and showed a total return on a representative list of common stocks over the 1879 through 1967 period at 8.2 percent *per annum* compounded. More astoundingly, and possibly more strongly supported by research, the Center for Research in Security Prices of the University of Chicago published in 1968 a study which showed that the average annual rate of return, compounded annually, invested in the common stocks listed on the New York Stock Exchange, for the period January, 1926, to December, 1960, was 8.8 percent. In addition, if you had picked a stock at random, with purchase date at random, and *any* later sales date at random, you would have made money 78 percent of the time and would have had a median total return of 9.8 percent. It is interesting to note that later CRISP studies, through December, 1965, show that for any ten-year period the annual return was at least 11 percent.

Drawing on this research data, Stanford has viewed its objectives from a *base* of 9 percent annual compound return. We have set for our total return investment pool, which we term our *Yield and Gain Pool*, a 10 to 15 percent total annual return objective over a three to five year span, with likely expectation that 1½ to 3 percent will be yield and the remainder appreciation. We invest only our quasi-endowment funds in this pool, retaining our pure endowment funds in our *Merged Pool*. This latter pool, however, received scrutiny at the time we created the Yield and Gain Pool. Our new objectives for the Merged Pool were set at a 9 to 12 percent total annual return, with expectation that 4 to 6 percent of this would be yield.

Investment goals and performance are in need of upgrading, but only in the absence of other overriding demands the institution requires of its investment funds. To know how we are doing, we have plotted our historical data on investment return. In the 1950's we had, albeit more informally, a balanced income and growth objective. Our desire was to produce a substantial yield in order to provide attractive faculty salaries and thereby develop into an internationally ranked university. We are, for example, included in the investment performance data in the appendix to *Managing Educational Endowments*. And, with some justification, we suffer in comparison to mutual funds that had maximum investment return as a sole objective. I define performance as achieving stated objectives. We had a dual objective, a planned use for our yield on investment and a resultant balanced investment goal. On a graph of balanced mutual funds, as derived from Arthur Lippe mutual fund data, one cannot distinguish between the line plots of the group and of Stanford. I believe we attained our objectives and therefore achieved satisfactory performance. And, recognizing the long-term implications of seeking a higher total return, we changed our investment objectives in 1968.

For general purpose use, whether or not you seek total return, state your investment objectives. Second, tabulate or graph your performance. A ten-year period is best, a five-year period is reasonable, and a three-year period may have to do for a start. You should operate on a pooled basis, with unit market values. Monitor performance, and calculate an actual total rate of return. Average more than one year, either a simple annual arithmetic or a more conservative geometric average. The object of any measure is to develop comparative data and to assist in bringing about an improvement in future investment performance. You must take account of as many factors as possible that are responsible for the performance. You might wish to separate funds into different pools, endowment and quasi-endowment, possibly between restricted purpose and unrestricted as well.

Revenue from Investment

I defined the total return concept, as applied to colleges and universities, as having a *dual basis*. Above, one facet, the investment performance objective, was considered. The second concerns revenue from investment. Systematic logic

is needed for the withdrawal of portfolio assets or, simply said, a prudent plan is necessary to spend appreciation. Any change in investment strategy to obtain higher total return generally means a larger commitment to equities, and a resultant drop in passive income due to common stock yields being less than bond interest. So, if an institution chooses to pursue a total return investment strategy, it is normally faced with the alternatives of either lower endowment yield for the next few years or the inclusion of some component of appreciation in a new definition of income and, maybe, a new word like *revenue*.

One big step toward redefinition, or at least how institutions should possibly interpret the laws having an impact on currently accepted definitions, was taken with the publication of *The Law and the Lore of Endowment Funds*. Reports and articles are now accumulating, with a common theme saying that revenue is anything legally available for expenditure. I would advise that an absolute first step is a written opinion by legal counsel for the specific institution.

When most lawyers are asked for an opinion, they seek to refer to the governing laws. The standard assumption, which may or may not be correct, is that endowment funds are governed by trust laws and by principal and income statutes pertaining to trusts. Typically, opinions based on these laws preclude the expenditure of appreciation, as income, on pure endowment funds. The NACUBO Investment Questionnaire, referred to earlier, showed that 12 of the 26 institutions adopting Total Return obtained legal opinions prior to any investment strategy change. Nine of these were obtained after the publication of *The Law and the Lore*, with six legal opinions agreeing with the Cary-Bright submissions.

I think it is important to step back at this point and note the ways in which total return is being applied. Of the 26 institutions referred to above, the greatest number (13) apply total return only to quasi-endowment funds, thereby avoiding the legal issue. Stanford is in this category, as are Chicago, Cornell and Duke. A second way may be called the "combination method," with a single investment pool, revenue calculated on a total pool basis but withdrawn only from quasi-endowment funds. Yale, Brown, Johns Hopkins, Berea and Pomona use this approach. A third way is to apply revenue formula on all funds without limitation, the method set forth in *Managing Educational Endowments*. Smith, Mississippi, and Knox follow this route. The Common Fund has the capability of providing any one of these, at the institution's request. A modified, fourth way would be to apply a revenue formula to all funds, provided they have appreciation. Dartmouth follows this approach, and will not expend gain on funds "under water," or, in other words, at a market value per share that is below book value.

The foregoing has been evidence of what is a second step in revenue determination, the logic or plan constructed to determine the *amount* and the *method* of withdrawal of assets from the endowment fund. Appendix B of *Managing Educational Endowments* sets forth one plan. The recommendation is to transfer each year, from endowment to operating funds, an aggregate amount equal to 5 percent of the three-year, moving-average market value of the fund, this amount being comprised of interest, dividends and, if necessary, appreciation.

You can develop very complex revenue formulae. Yale's "University Equation" is probably the most complex, and the annual re-formulations have done nothing to allow us to better understand what is, and has been, done. Probably the most articulate formulation is that of Princeton. In February, 1970, they published a 50-page report on *The Definition of Endowment Income* as it pertains to Princeton. Recent legislation in New Jersey appears to have paved the way for Princeton to begin using its new income definition.

A reasonable, middle-of-the-road revenue formula, may well be that of Dartmouth. The Dartmouth approach emphasizes the necessity for the institution to make a "prudent determination" of the portion of total return to be used in any one year. This "prudent determination" of revenue is arrived at by calculating a 4.9 percent amount of a three-year moving average, using quarterly data. To accommodate the budget officers, the average is set back one year. This means they know the amount determined by formula in advance of the current operating year. In addition, there are checks and balances to insure the continuing logic of the amount of revenue formulated and to make certain that it is a prudent amount. For instance, every six months they compare the revenue distributed against the sum of bond interest earned, plus dividend yield on stocks, plus a new wrinkle, the increase in retained earnings of companies in which they have invested.

Uniform Management of Institutional Funds Act

In describing events now occurring, I would like to alert everyone that a Uniform Management of Institutional Funds Act is currently being drafted under the guidance of the National Conference of Commissioners on Uniform State Laws.

Essentially, the Uniform Act, as currently drafted, takes the position that to date *no* law has been directly applicable to endowment funds. Therefore, this law being created shall apply to all endowment funds given or made before and after date of enactment. The draft develops definitions for "endowment fund," "institution," "governing board," and "income."

Possibly the most significant part is the determination of

spendable income, wherein the draft states this may be defined as the Board shall deem reasonable and prudent considering the present and future needs of the institution. Considerable debate has centered on standards of reason and prudence. There was general agreement that principal should not be expended *below* the recorded gift book value of the fund. What was unclear, however, was whether or not the law should go further to define a revenue formula. If it did not, should there be some prohibition on spending appreciation from book value to date of enactment, to prevent immediate withdrawal of many years' accumulated gains?

By way of additional background, a further revised draft of the Uniform Act will be discussed by the Advisory Committee in early 1972. The objective is to proceed with the development of a final draft for a second presentation and final approval at the National Conference of Commissioners in August. After final approval, the Uniform Act will be provided and available to state legislators for the sessions typically beginning in January, 1973. Given the foregoing events, you very likely will see the Act becoming law in many states in 1973.

Tax Legislation

Another area of concern to many of us in investment management is recent tax legislation, especially the Tax Reform Act of 1969. This Act, in part, amended the Internal Revenue Code regarding the deductibility of charitable contributions where the donor reserves a life income interest for himself or other beneficiaries.

In general, the Act provides that in order for the charitable deduction to be allowable, a reserved income gift must be made in the form of (1) a charitable remainder unitrust, (2) a charitable remainder annuity trust, or (3) a gift to a pooled income fund.

One investment management comment relevant to all three categories is the Act's reference to long-term gains as being a return on principal. The inference is that short-term gains are to be considered as income for tax purposes. Hence, until things become more clear as to legal interpretation we follow a policy of "don't ever sell anything held by the fund under six months or you will incur a tax liability for the beneficiary without any income paid out."

Looking at the unitrust and annuity trust, we see these as separately held life income funds. A new element is the set interest rate, specified by the donor, that guides the amount of income paid out. Even if the donor accepts the optional set rate or whatever is earned, the desire is known and quite often may be higher than past yield history or similar funds. The fact of a specified income expectation has an impact on security selection, with a typical result being investment in high coupon, long-term bonds. To better manage funds, we have found it desirable to purchase in large denominations, and to hold positions in one of our investment pools or a separately held unrestricted fund. Then, as appropriate, we allocate small portions to a unitrust.

We have created, as well, a Pooled Income Fund. The regulations governing such pooled funds were published in the *Federal Register* on July 17, 1970. We have found that the tables for arriving at the present value of the charitable remainder interest result in much lower decimals to be applied to the current market value of property given than those previously used. Also, we have found it prudent to create the pool, by drawing some funds out of our Merged Endowment Pool, through an extremely rigorous accounting of assets transferred in order to comply with the regulation that "the property so allocated to the (pooled income) fund be representative of all commingled property" in the existing pool. We invest this pool to obtain objectives identical with our Merged Endowment Pool. No short-term sales are made. The most difficult investment management problem to date appears to be the fact that we now have another, separate pool to manage.

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